Securities Industry Trends

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AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
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THE DELPHI STUDY - KEY FINDINGS AND IMPLICATIONS FOR FIRMS

This issue of Securities Industry Trends reviews the presentation on the "Delphi Study - Key Findings and Implications" made at the 1985 SIA Spring Management Conference. The main purpose of the presentation was to provide firms in the securities industry with analyses to assist in future planning decisions.

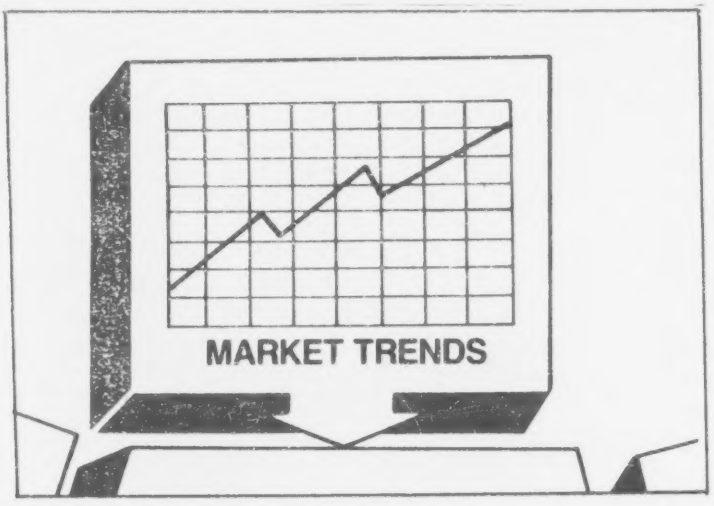
In the Spring of 1984, SIA and Arthur Andersen & Co. undertook a joint Delphi Study of future trends in the securities industry, entitled Keys to a Changing Securities World. The study took nine months to complete, and the results indicate the collective thinking of over 600 individuals involved in the securities business. These individuals, whose very actions can influence the future, were divided into panel groups. The panels consisted of: CEOs of securities firms, senior management at firms, CEOs of competitor organizations, regulators and legislators, and industry observers such as academics, lawyers and analysts. In addition, institutional, retail and corporate customers were surveyed.

The Delphi Study describes how participants believe the securities industry will evolve during the late 1980s. Panelists predicted how key forces of change would alter industry structure and how firms, in turn, would respond to these changes, thus precipitating even more change.

We will discuss several of the key findings of the study and their possible implications for securities firms. However, the real practical value of the Delphi study would be for each firm to examine the key findings on competition, products, costs, etc., and to determine whether or not they agree with the assumptions and findings. From this exercise, firms will derive their own picture of the securities business as it may exist in the late 1980s and will be in a position to say: Here's our best perception...what do we do about it?

This paper is designed to help advance the process of using the SIA/AA study as a basis for discussing planning and strategy within individual firms. The Study is a guide, not a blueprint.

It is necessary to first set the stage. How did our Delphi participants view the operating environment in the late 1980s? (Chart 1)



Not surprisingly, panelists projected greater share volume. NYSE average daily share volume is projected at 135 million shares in 1988, compared to 85 million shares in 1983 and 91 million shares in 1984. As of the end of March, average daily share volume in 1985 was 108 million, up 18.5% from last year.

NASDAQ average daily share volume was predicted at 102 million shares in 1988, compared to 63 million shares in 1983 and a slight drop to 60 million shares last year. Through the first three months of 1985, average daily share volume has been 82 million, up 36% from 1984.

In effect, panelists project a slowdown in the annual rate of growth in volume to 10% during the 1984-88 period for both the NYSE and NASDAQ. This compares with growth

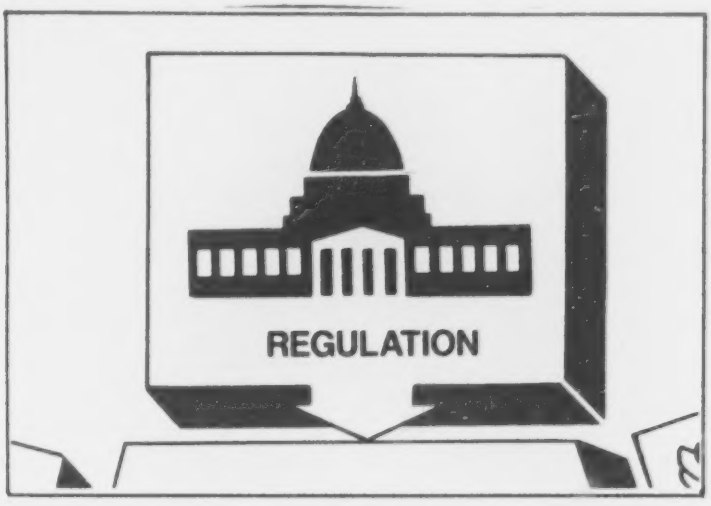
rates of 25% and 42% for those markets, respectively, from 1978-83. Even though activity was up sharply during the first quarter of 1985, the increase trails those from 1978 through 1983.

To predict volume is almost as perilous as predicting stock prices or interest rates. Nobody is able to predict what levels of activity will be for the rest of this year or over the next few years, but firms may want to consider the implications of a slowdown in expansion relative to the period of 1978-1983. What does this mean for various expenses, including the hiring of sales persons and other personnel?

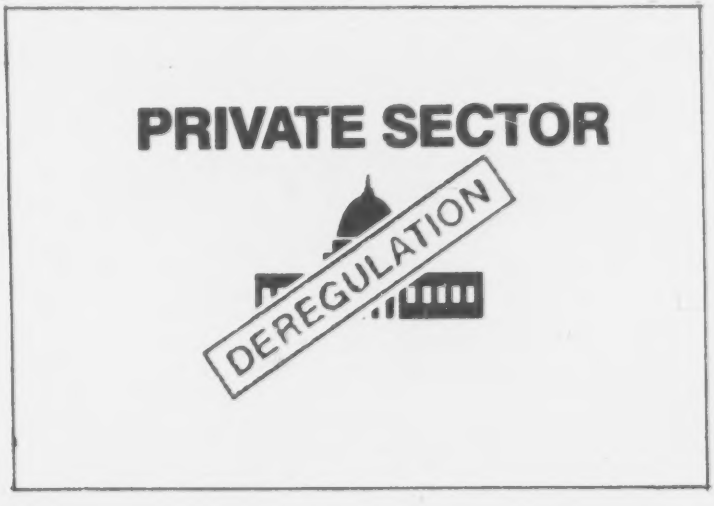
The strong dollar in 1984 and the record amounts of foreign capital inflows make internationalization of markets a very relevant topic. Since the late 1960s, foreigners have played a major role in the U.S. equity market. We estimate they account for about 10% of public volume on the NYSE and their net purchases probably comprise 20%-25% of net additional stock issued each year. However, with the depressed stock market last year, foreigners were net sellers of U.S. equities while purchasing massive amounts of U.S. fixed income instruments. On the other side of the ledger, more and more individuals expect U.S. money managers to invest in foreign companies as a way of diversifying and seeking out new opportunities. Clearly, the relative strength of the dollar has much to say about this trend.

Delphi panelists expect internationalization of markets to increase, with the pace faster in debt instruments. Much has been made and said about 24-hour trading markets. However, no one has been very specific about what increased internationalization means for firms. Internationalization has already progressed substantially in debt instruments with the rapid growth of the Eurobond market. Individuals from one country are buying obligations of issuers of other countries. In the international trading of equities, this is likely to proceed at a slower rate because equities lend themselves less to commodity-type transactions as compared to debt instruments. Firms will most likely want to consider what internationalization means in terms of their bottom line. Moreover, some regulatory issues are raised by internationalization.

No topic concerning the financial services industry has received more attention than regulation. What were the participants' views on future regulation? (Chart 2)



Participants from the private sector believe there will be further deregulation for all sectors of the financial services industry. (Chart 3) Panelists from the



public sector, i.e., regulators and legislators, do not agree that future change will necessarily be deregulatory in nature. (Chart 4) What is the end result? We may see increased regulation in certain areas, and less regulation in others. Also, regulation is here to stay and meeting its demands will continue to have a major impact on management practices and costs.

PUBLIC SECTOR

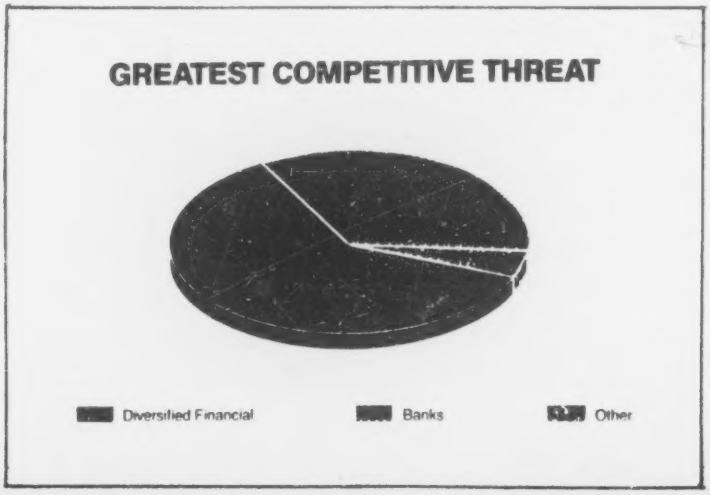
The Delphi Study implies that there will be a protracted struggle between the private and public sectors over future regulatory changes. Given recent events in the government market, we can expect more rather than less regulation in this area. Practically speaking, time spent in reviewing possible trends should allow firms (1) to identify possible areas of regulatory change, (2) put an assessment of likelihood and timing on each, (3) decide what each change would mean to the firm and (4) what, if anything, to do about it. In other words, time to get ready. The securities industry and other financial service sectors may become increasingly frustrated with the slowdown in the trend toward further deregulation, in light of possible additional regulation in certain key sectors. For example, the recent problems of Bevill Bresler & Schulman and ESM give rise to the likelihood of increased regulation in the government securities market.

Deregulation, or rereg'lation as some will call it, can affect any of a wide range of areas. Will there be removal or easing of the McFadden Act's restrictions on interstate banking? What about easing of margin regulations, changes in non-bank bank opportunities, or the ability of banks and brokers to enter each other's businesses. Future deregulation will, in some cases, pave the way for future competition. The likelihood is that pressure for these developments to take place will continue unabated and that future planners for our industry should be very conscious of the potential for change in these areas.

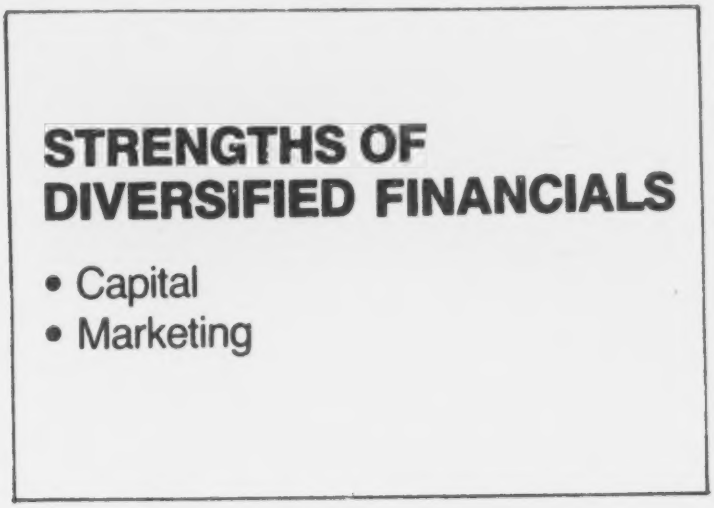
Participants put a great deal of emphasis on greater competition from non-traditional competitors, (Chart 5)

banks, insurance companies, retailers and international organizations. Management's first challenge will be to accurately size up the competitor's strengths and weaknesses, as well as the programs and products actually being offered. Market research into these competitors' practices is a must. Where are competitors the most vulnerable? What do competitors offer customers that securities firms don't? What tactics should a firm take to prevent the erosion of its customer base? Competition may force some firms to continue to offer new products despite a general recognition that many of these products are not needed or wanted by most customers and add to overhead costs.

According to the Delphi study, the greatest competitive threat will come from the diversified financial service company, followed by banks. (Chart 6)



The strengths of the diversified financial firms lies in large capital bases and more consumer oriented marketing abilities. (Chart 7)



Firms feel a greater need to attract additional capital. Ownership equity by year-end 1984 was over $12.7 billion, with total capital exceeding $16 billion. However, as a percentage of total assets, ownership equity was only 4.6%, down from 5.5% at year-end 1983. The industry's use of leverage was at a ten year high at year-end 1984. The trend toward principal activities and away from agency business has clearly intensified capital needs of securities firms.

If the strength of the diversified financial firms lies in capital and marketing, firms will want to identify which areas diversified financials will be powerful competitors in? Trading? Investment banking? Technology? Training? Mass merchandising? By identifying areas such as these, firms can begin to decide where they want to compete and, in those cases, how they can compete given what may be vast differences in resources.

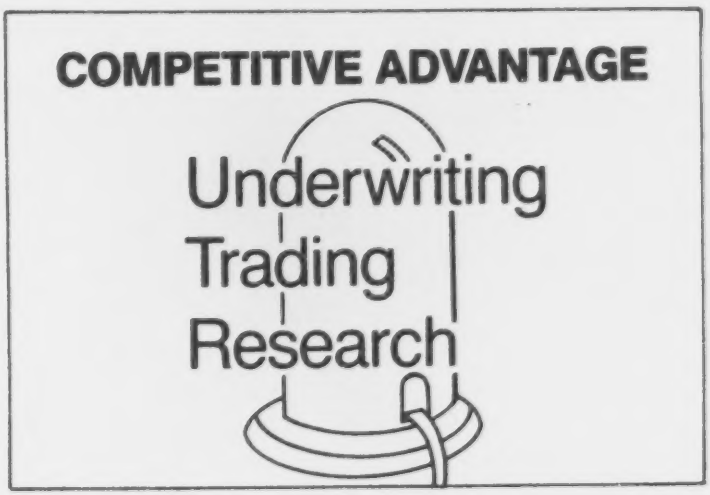
Not all firms will want to compete in every area. Some firms will clearly decide that they do not want to offer a multitude of products to all customers. Firms have been starting to question the range of products and services they now offer. In the future, they may be more interested in determining whether a particular product or service is profitable rather than simply whether another competitor offers a similar product or service. Many firms are now not only questioning the range of products and services they recently created, but the fixed overhead that comes along with many of these innovations. Choosing which businesses to eliminate or reduce may be a more

important managerial decision than deciding which new business to enter or existing business to expand in. Moreover, what will become of critical importance will be the ability of firms to understand target markets, because in many cases firms as well as competitors will be going after the same markets.

As we are beginning to see, being a financial supermarket does not necessarily guarantee success. Delphi participants felt that a financial supermarket may not succeed because of: (1) lack of management expertise in all business lines, (2) customer nonacceptance, and (3) an inability to retain key staff.

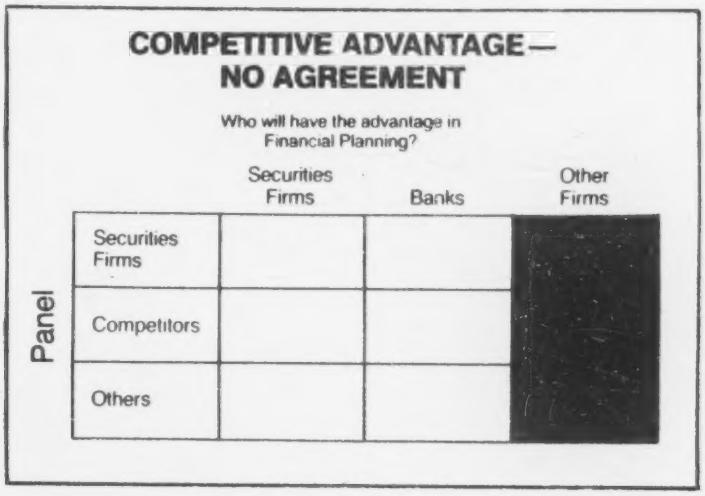
Firms are well aware of the problems of retaining key personnel when mergers take place. Often, many of the key personnel, for various reasons, choose to leave the merged entity to go elsewhere. An intimate knowledge of the industry and a specific corporate culture developed by the needs of a very dynamic business will still be major competitive advantages for smaller securities firms.

In the future, panelists project that the securities industry will retain competitive advantages in underwriting, trading and research. (Chart 8) Banks will



have a competitive advantage in discount brokerage, transaction-oriented activities, and credit products. (Chart 9) Neither the securities industry nor banks will

have an edge in offering financial planning services. Given the fact that many securities firms and deposit taking institutions are engaged in plans to combine teams of individual specialists to provide comprehensive financial planning to their customers, the lack of enthusiasm indicated in responses by customers should be weighed carefully. (Chart 10) There still remains a lot



of work to do in convincing customers that securities firms or banks or any one institution should handle all of their financial planning.

What does the retail customer really want and need? How did the securities firms compare with competitors in evaluating the needs of the retail customer?

Although customer preferences were ranked in the top three factors affecting the securities business, the Delphi survey showed that neither the securities industry nor its competitors fully understand the needs of the retail customers. (Chart 11) Among the differences were

the following: Firm image is very important to the retail customer, but this value was ranked lowest by the providers of financial services. (Chart 12) Customers

ranked soundness and stability as the third most important value, while competitors ranked it low. The securities industry ranked variety of products and services the second most important variable; however, this value was no better than a fourth consideration for the retail consumer.

It is helpful to focus a moment on one of the most important values to our customers -- firm image. Financial service providers have not taken into account the customer perspective of the abstract term "image". Providers may be defining image in too narrow a sense, while "users" or our customers may define it as embracing reliability, integrity, competence -- and other factors that are understandably important to people in matters concerning money. If that's so, then there could be a powerful competitive advantage in seeking to project an image that conveys those attributes to customers.

Clearly, the difference between what customers want and what financial intermediaries think they want argues for increased market research at firms. Good readings on customer preferences will become critical as the industry and its competitors compete head-on for retail customers. There are signs that the sales orientation of many firms has already begun to change, as marketing research has gotten increased attention in recent years.

Marketing and product development was, in fact, picked by Delphi panelists as the number one choice for gaining an edge over competitors. Other choices given were strategic planning, entrepreneurial talent, productivity and technology. However, although some firms have added marketing expertise in recent years, an SIA survey shows that not more than maybe 30 firms have a fairly senior person devoting full time to marketing management.

Input from the sales force can be a powerful marketing tool. And it has been! RRs are the industry's traditional pipeline to the customer. Competitors, on the other hand, do not have salesmen as close to customers as our industry does. Hence, using RRs for input is a valuable edge. But few firms have capitalized on the opportunity to use this input in a <u>systematic</u> way. There may be many opportunities yet to be explored in the area of RR feedback.

It will be important in the future to augment RR input periodically with market and customer research. This would require the establishment of methods to directly survey customer needs and desires. One of the major challenges to firms will be to implement direct customer marketing without alienating the salesforce.

Indeed, much has been written about the changing role of the RR. According to the Delphi study, many securities firm executives and competitor CEOs believe RRs will become financial advisors supported by salaried experts. (Chart 13) However, external competitors believe there

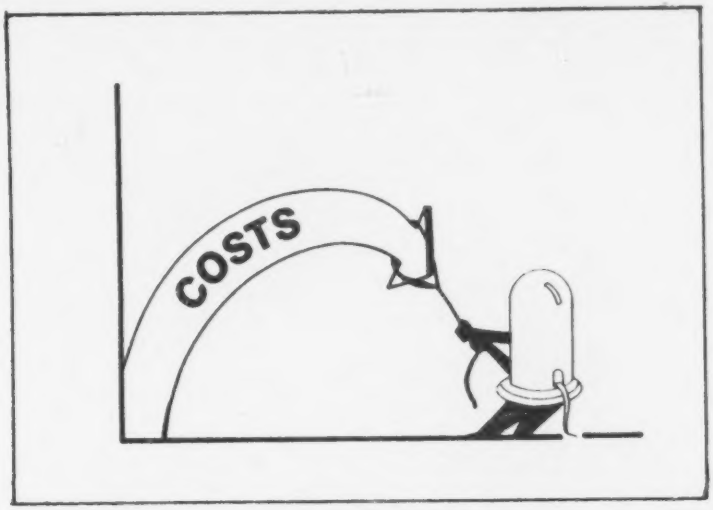
CHANGING ROLE OF THE ACCOUNT EXECUTIVE

	PANEL	
	Securities CEO's	Competitors CEO's
Become a Financial Advisor	46%	54%
Have Reduced Importance Due to Technological Advance	11%	31%
Remain Unchanged	24%	11%
Have Increased Importance	15%	4%

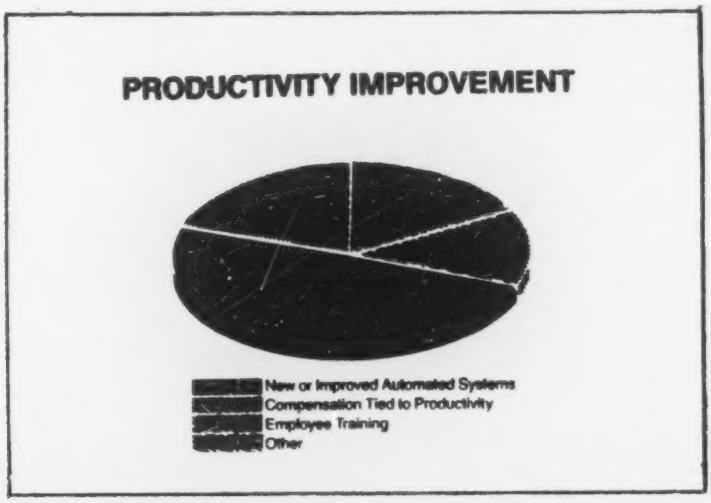
will be reduced importance on the role of the RR. This may be wishful thinking on their part, but competitors also indicated that they will stress service that is less dependent on personal relationships. It might be useful to consider why competitors believe RRs will have reduced importance. One obvious reason is because they don't have such a salesforce and probably don't intend to build one. Another reason is that the RR system is a high cost method of distribution.

The question might also arise whether an extensive branch distribution system makes any sense in the future. This is an advantage for the securities industry and a disadvantage for external competitors. However, it also has some disadvantages for the securities industry in terms of expenses. More and more firms are revisiting their compensation packages to make sure that the RR is being rewarded when he or she should be.

The securities industry has seen a dramatic escalation in costs in recent years. What did the Delphi participants have to say about that? (Chart 14)

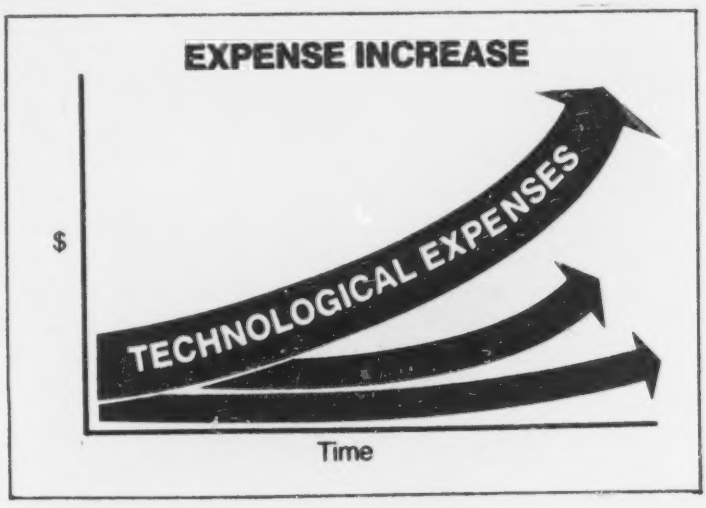


CEOs of securities firms and external competitors projected that cost control would be the most important factor affecting the profitability of securities firms in the late 1980s. To control expenses, industry management will focus on increasing employee productivity. This additional productivity will come from new or improved automated systems, followed by employee training programs and compensation tied to productivity. We are also more likely to see networking arrangements between firms as a way of reducing costs by sharing a service or facility. (Chart 15)



For any firm to control its costs, it must be able to accurately identify and categorize its cost components. The benefit to a firm of providing a particular product or service or the value of any one client is, in part, measured by their respective revenues and expenses. Improved cost collection and analysis techniques will enable management to make better decisions on how and where to deploy firm assets. This same concept should be extended to product line profitability. As product lines continue to grow almost to unwieldly levels for effective management control, this will become critical.

Technology costs will rise more than any other cost category. (Chart 16) Clearly, in the past, technology and

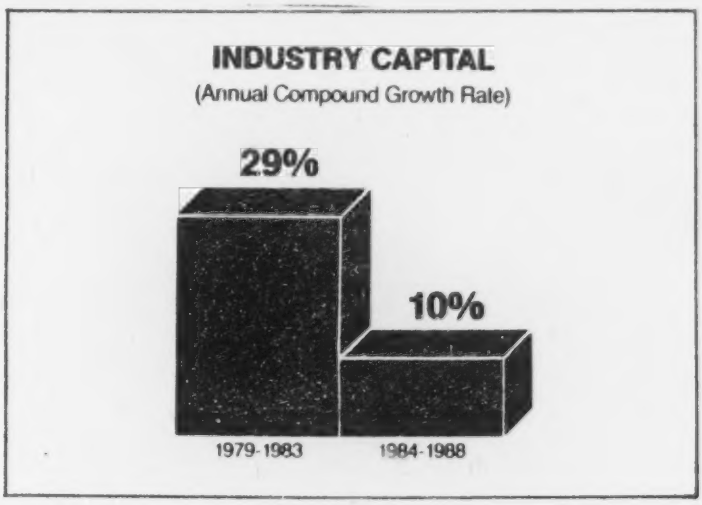


communications costs have increased faster than other costs, which also have grown substantially. The industry projects that more and more money will continue to be spent on technology and communications in order to remain competitive.

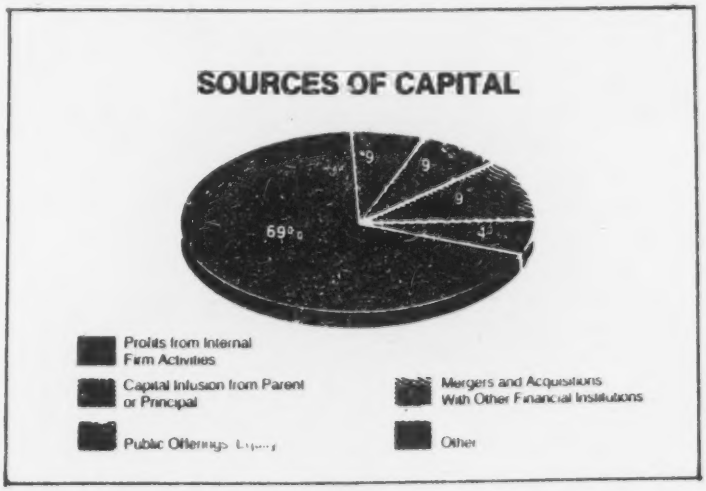
There is an uneasy feeling that these particular costs may be out of control. The reason for this is contained in another Delphi finding: Despite the increased costs and additional spending on technology, panelists believe that technology will not substantially improve their competitive advantage. So although firms have spent substantial sums on technology in the past and plan to do so in the future, it is clear that they really do not see how technology provides them with a competitive edge. They are not even certain how it translates to the bottom line, such as a reduction of expenses in terms of processing numbers of transactions that would not have been possible five years ago.

What did the Delphi panelists foresee as the overall financial health of the industry?

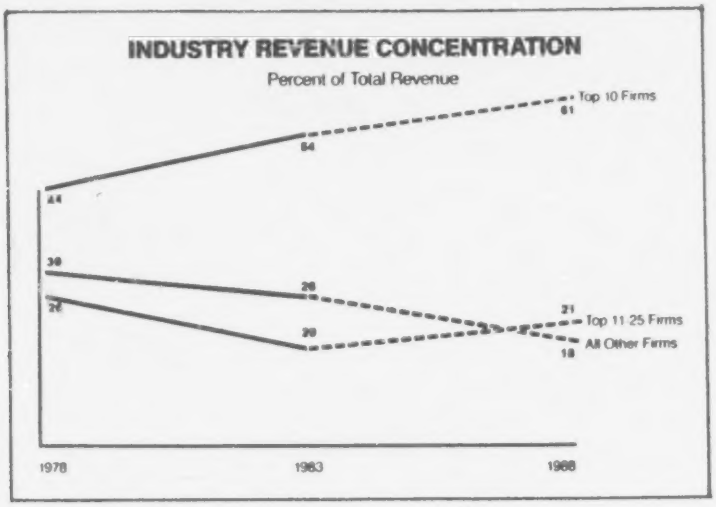
Capital is expected to grow about 10% from 1984-1988. This compares with 29% from 1979-1983. (Chart 17) Most of the additional capital, about 70%, is



expected to come from retained earnings. (Chart 18) Big increases in capital in this industry took place after 1979. Since 1978, capital has increased by a factor of almost 4 in the securities industry.



In terms of concentration, Delphi panelists expect revenue concentration will continue to grow, from a 54% market share in 1983 to a projected 61% in 1988 for the top 10 firms. (Chart 19) This increased market share is



projected to come at the expense of smaller firms. This says nothing at all about the profitability of different size firms. Profitability and firm size are unrelated in the securities industry.

Commissions are expected to decline in relative importance, while trading and investment profits will become more important. Actually, on an annual basis, in 1984 trading and investment profits were a larger percentage of revenues than commissions for the first time ever. This has been one of the most important factors affecting the structure and plans of the securities industry. Additional capital has been required and different products developed for hedging and other strategies that minimize risk, while firms are committing capital to positions. On the other side of the ledger, discounters have kept the level of increases in retail rates modest and intense competitive pressures have kept institutional rates at lower levels.

Given this emerging picture of the industry in the late 1980s, how will firms be managed. According to Delphi panelists, the management style of both securities firms and external competitors will have at least these four common characteristics: (1) centralized decision making, (2) long-term profit perspective, (3) higher levels of risk-taking, and (4) more entrepreneurialism. (Chart 20)

SIMILAR MANAGEMENT STYLES

- Centralized Decision Making
- Longer Term Profit Perspectives
- Higher Levels of Risk Taking
- More Entrepreneurialism

This is an overall picture and management style will no doubt vary with size, business and ownership of firms. For example, the deeper the pockets, the more likely a longer term profit perspective. In structuring a management approach, each firm needs to tailor it to its financial resources, quality of management, type of business, etc. We hope that this presentation and the Delphi Study will assist you in going further in discussing the implications with your own management team.

The Delphi Study, as mentioned earlier, is intended as a guide -- food for thought -- not as a precise road map, and it should be considered accordingly -- as another tool in planning for the future.

Edward I. O'Brien
President
SIA

Stephen G. Racioppo
Partner
Arthur Andersen & Co.

Jeffrey M. Schaefer
Senior Vice President
SIA

SECURITIES INDUSTRY STATISTICS

VOLUME

	March 1985	YEAR-TO-DATE 1985	March 1984	YEAR-TO-DATE 1984	% CHG. Y-T-D 1985 - 1984
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	102.6	113.2	84.3	95.5	18.5%
AMEX (MILS.)*	8.7	9.4	5.4	6.3	49.2
NASDAQ (MILS.)*	76.7	83.1	57.8	61.3	35.6
REGIONAL EXCHANGE (MILS.)*	20.2	19.6	12.4	14.1	39.0
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	76,916	242,187	63,905	209,003	15.9
AMEX (MILS.)	2,465	7,025	1,646	5,579	25.9
ODD-LOT SHARES PURCHASED ON NYSE (THOUS.)	6,618	20,375	7,242	22,390	9.0
ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	16,404	49,510	13,729	41,375	19.7
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	50.9	51.0	49.6	49.3	---
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	12,060	37,236	9,515	29,075	28.1
AMEX OPTIONS	2,914	9,131	3,591	9,973	(8.4)
COMMODITY	13,602	39,667	13,959	37,597	5.5

** MONTHLY AVERAGE*

YIELDS

(MONTHLY AVERAGES)

	March 1985	March 1984	Basis Point Chg. Mar. 85 - Mar. 84
BOND BUYER INDEX (20 BOND)	9.77	9.97	(20)
CORPORATE BOND YIELDS (MOODY'S)			
Aaa CORPORATE	12.56	12.57	(1)
Baa CORPORATE	13.69	13.99	(30)
RATIO Aaa CORPS. TO Baa CORPS.	0.92	0.90	----
MUNICIPAL BOND YIELDS (MOODY'S)	9.77	9.41	36

PRICES

(END OF MONTH)

	March 1985	March 1984	% Change Mar. 85 - Mar. 84
DOW JONES INDUSTRIALS	1266.78	1164.89	8.7
STANDARD & POOR'S 500	180.66	159.18	13.5
NYSE COMPOSITE	104.60	91.67	14.1
AMEX MARKET VALUE INDEX	229.59	211.30	8.7
VALUE LINE COMPOSITE	194.53	182.19	6.8
NASDAQ COMPOSITE	279.20	250.78	11.3

UNDERWRITING
(DOLLARS IN MILLIONS)

	FIRST QUARTER 1985	FIRST QUARTER 1984	% CHANGE 1985 - 1984
CORPORATE FINANCING (Gross New Issues)			
Total	21,017	17,909	17.4%
Common Stock	4,237	2,271	86.6
# of Common Stock Issues	126	167	(24.6)
Preferred Stock	1,045	1,114	(6.2)
# of Preferred Stock Issues	15	19	(21.1)
Corporate Debt	15,734	14,524	8.3
# of Corporate Debt Issues	227	183	24.0
MUNICIPAL FINANCING (Gross New Issues)			
Total	22,707	22,731	(0.1)%
Notes	1,802	8,138	(77.9)
Bonds	20,905	14,593	43.3

MARGIN DEBT

	March 1985	March 1984	% Change Mar. 85 - Mar. 84
MARGIN DEBT OUTSTANDING ($MILS)	23,320	22,460	3.8%
NET CHANGE IN MARGIN DEBT ($MILS)	860	8,290	(89.6)
% OF ACCOUNTS WITH EQUITY UNDER 40%	11	11	-------

* ALL TIME HIGH

FINANCIAL DATA FOR NYSE FIRMS DOING A PUBLIC BUSINESS
(MILLIONS OF DOLLARS)

	Fourth Quarter 1984	Yr.-To-Date 1984	Fourth Quarter 1983	Yr.-To-Date 1983	% Change 4th Q. 1984 4th Q. 1983	Yr.-To-Date % Change 1984 - 1983
REVENUE						
SECURITIES COMMISSION INCOME	$1,708	$7,095	$1,877	$8,326	(9.0)%	(14.8)%
REALIZED AND UNREALIZED GAIN OR LOSS IN TRADING AND INVESTMENT	2,577	8,278	1,659	7,571	55.3	9.3
PROFIT OR LOSS FROM UNDERWRITING AND SELLING GROUPS	871	2,706	812	3,537	7.3	(23.5)
TOTAL REVENUE	8,518	31,216	7,245	29,515	17.6	5.8
TOTAL EXPENSES	8,015	29,608	6,928	25,706	15.7	15.2
NET INCOME BEFORE TAXES	503	1,608	317	3,809	58.7	(57.8)
PERCENT OF FIRMS SHOWING LOSS	36.2%	36.5%	37.3%	14.5%	---	---

RECENT INTERESTING READING AND STATISTICAL MATERIAL

ITEM	DESCRIPTION	SOURCE
Keys to a Changing Securities World	SIA/Arthur Andersen Delphi study of the securities industry in the late 1980s, on which the presentations at the SIA Spring Meeting were based.	Communication Services Arthur Andersen & Co. 69 West Washington St. Chicago, Illinois 60602 $50 SIA members; $75 others
Sources--The Securities Executives' Guide to Products & Services	Classified buyer's guide to industry-related products and services. With more than 300 directory listings covering 80 different categories, this reference book includes hardware and software vendors, securities clearing firms, training institutions and travel agents.	SIA Publications Department
Fact Book 1984 NASD	Statistical review of NASDAQ activity in 1984, with certain historical data tracing developments since 1974. Lists individual performance data for each security in the NASDAQ National Market System as well as NASDAQ securities not in the System.	National Association of Securities Dealers, Inc 1735 K Street, N.W. Washington, D.C. 20006
Annual Financing Report	Reviews and ranks activity in Eurobond market and market for Euroloans and notes in 1984. Included are rankings of: lead and co-lead managers for all issues, all currencies, co-managers, bookrunners for dollar issues and non-dollar issues.	Euromoney Supplement April 1985
The Role of High Yield (Junk Bonds) in the Capital Markets & Corporate Takeovers: Public Policy Implications	Report examines high yield bond market, including risk-reward calculations, place of high yield instruments in overall structure of capital markets, and use of these securities in takeover situations. Existing regulatory situation is discussed along with policy options for additional legislative action.	Paper 85-694 E Congressional Research Service Library of Congress Economics Division Washington, D.C. 20540

ITEM	DESCRIPTION	SOURCE
The Tax Directory	Comprehensive reference to congressional policymakers, executive branch policymakers, tax-related organizations, and Treasury and IRS. Includes names of key people and staff, titles, phone numbers and mailing addresses.	Tax Notes Magazine 6830 North Fairfax Drive Arlington, VA 22213 $7.50 Prepaid
Managers of America's Wealth	Issue based on annual survey of largest money managers. Profiles of over 900 managers which include investment approach, asset mix, assets managed, and key people.	Pensions & Investment Age Special Profiles Issue 5/6/85
Annual Report 1984	Focuses on the uneven economic performance of the world economy in 1984 and present problems and future risks. Reviews four troublesome factors that could undermine world progress: U.S. deficit, slow growth in Europe, protectionism, and the vulnerability of the LDCs.	Public Relations Federal Reserve Bank of New York 33 Liberty Street New York, N.Y. 10045
"The Troubled Market in Federal Securities"	Reviews the workings of the government securities markets, collapse of ESM and Bevill Asset Management, and suggested remedies entailing increased regulation. Concludes: Too many rules would be worse than too few. Author's solution: Give the NY Fed authority to examine books of any government securities dealer.	Fortune 5/13/85
"Commodity Prices in the Current Recovery"	Reviews the recent behavior of commodity prices in cyclical and longer term context, analyzes determinants of current expansion, and discusses medium-term price prospects for a few commodities.	Quarterly Review Federal Reserve Bank of New York